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Stock prices were rising three times more rapidly than earnings. There was no statistical precedent by which to judge to what degree prices were entitled to outrun earnings, but when stock quotations get to stepping thrice as high as the intrinsic values behind them, it should be time for careful people to stop, look and listen.

Prof. Irving Fisher, *The Stock Market Crash and After*, Dec. 1929
The Macmillan Comp., New York

Crisis in the Making

The perception that the U.S. economy is healthy and vibrant today has tremendous logical support: A truly extraordinary confluence of strong GDP growth, low consumer price inflation, strong income growth, low unemployment, a balanced federal budget, surging stock and asset prices and near-record consumer confidence. Toss in exciting growth in computers and communications, and it becomes a most sensational and seductive story. But as much as one would like to believe it, and as diligent as Wall Street is in endlessly propagating this wonderful tale, the truth is that it's but a fictionalized account of the dangerous American bubble. A true account would not exclude the issue of credit. Indeed, the growth of unprecedented credit excesses should be the paramount story line.

Today, more than ever before, it is critical to recognize that decades of hard work, high savings, heavy investment and great technological advancement in Asia proved no match for the destruction caused by a few overzealous years of runaway credit growth. Indeed, the sad irony remains today, as it has throughout history, that hand-in-hand with every new era/miracle economy comes the egregious credit excesses that destroy both the economy and the financial system. Adherents to the miracle are always blinded by the boom, failing to see credit excess as the undeniable determinant. And repeatedly, the terminal error is made to extrapolate the credit bubble's effects to the future, rather than recognizing that the crescendo of unbridled credit excesses mark the top in the cycle with the painful bust soon to follow.

Wildly optimistic extrapolation permeates America today, emboldening consumers, businessmen, politicians, bankers and investors. Excesses have created over-optimism; over-optimism has fed ever more dangerous excesses. And akin to the catastrophic financial and economic earthquake that hit Japan and SE Asia, the impending U.S. downturn is poised to hit a deceptively frail financial and economic foundation. The consumer sector, ex capital gains, is tapped out with a monstrous debt load and negative savings. The business sector is running a huge cash flow deficit while in the midst of a historic and unsustainable borrowing binge and aggressive expansion of dubious enterprises. In the financial sector, overleveraging and reckless speculation are endemic as never before. The combined excesses of all three sectors underlie the unprecedented U.S. stock market and economic bubble, against a global backdrop going from bad to worse. In short, the entire system has been stretched to the limit and is an accident waiting to happen.

Today, two momentous and related stress points are about to fail in the U.S. bubble. First, the highly leveraged financial sector appears acutely vulnerable to rising interest rates as well as to $100s of billions in

low-quality credit to borrowers whose fortunes rest with a continuation of the U.S. financial and economic boom. Second, the doddering stock market bubble today is keenly susceptible to any disturbance, especially after several months of liquidity-driven advances and astonishing speculative excesses. This manic stock market, particularly the technology and communications sectors, is replete with companies whose fortunes require a continuation of the financial and economic boom. Indeed, herein lies today's dilemma: Both the credit and stock markets have huge exposure to companies and industries acutely vulnerable to any meaningful deterioration in the market and/or economic environment.

OMINOUS DISAPPEARANCE OF LIQUIDITY

Mr. Greenspan's well-orchestrated massive reliquification of the U.S. financial system, replete with historic money and credit growth and a speculative run in the U.S. stock market, appears to have run its course. Indeed, both bank credit and money supply growth went stagnant in January after an explosive fourth quarter expansion. In addition, bank loans for security purchases, having grown better than 50% this past fall, are now contracting. Bank purchases of non-Treasury securities have declined 10% over the past two-months and the 13-week growth rate for commercial and industrial loans, having spiked above 20% in the fourth quarter, has now fallen back to almost zero.

Moreover, the unsung heroes of financial market reliquification, Fannie Mae and Freddie Mac, have become notably less frenetic. After growing their balance sheets by an astonishing $88 billion during the fourth quarter, an annualized rate of about 50%, their mortgage portfolios grew in January at a tepid $6 billion, or about a 3% annual rate. We do not know if Fannie's and Freddie's newfound prudence is related to the rundown of the prodigious mortgage refinancing boom they incited, a response to a surprising and problematic surge in interest rates after they ballooned their balance sheets with low yielding mortgage paper, or something else. Their abrupt change of course, however, is certainly a prominent factor behind the downturn in financial system liquidity. It appears a return to last summer's liquidity crisis is lurking.

Signs of a developing credit crunch are certainly evident in the database of Securities Data Corp. Their data show year-to-date declines in credit market security issuance. New corporate investment grade debt issuance of $93 billion is running 10% below last year; municipal debt of $28 billion is 21% below last year; syndicated loans of $28 billion are 69% below, and junk debt issues of $16 billion are 28% below comparable 1998 levels. Interestingly, equity market IPOs are bucking the trend with $19 billion of new issues so far this year, fully 44% above last year. We don't see this divergence lasting much longer; irrationally exuberant equity investors can ignore the deteriorating liquidity position of the credit markets for only so long.

Today the entire universe of U.S. credit market instruments trade poorly, from T-bill contracts to junk bonds. The U.S. cash long bond that began the year with yields at 5.1% now yields almost 5.5%. The 10-year cash T-bond that traded briefly below 4.2% in October now yields 5.2% and the five-year bond now yields 5%, after trading below 4.5% in January. The two-year Treasury note, which traded at 3.8% in October and began 1999 at 4.5%, now yields 4.95%. Moreover, yields on treasury futures contracts, used extensively for hedging, have surged dramatically. Yields on the March five-year and 10-year treasury futures have surged to almost 5.4% and 5.9%, after ending January at 4.9% and 5.5%. The five and 10-year futures are the key contracts used by the hedge funds and Wall Street firms to hedge mortgages and corporate debt issues. We believe their poor performance strongly supports our contention that a huge overhang of debt instruments is now held by the highly leveraged Wall Street speculating community.

SEEMING FINANCIAL AND ECONOMIC MIRACLE

Concomitant with the fourth quarter's extraordinary reliquification was an unprecedented flood of money

and credit growth with broad money growing more than $200 billion and non-financial debt more than $250 billion. Companies that were petrified with the prospect of a protracted loss of access to capital markets only weeks before, showed up in droves as soon as the Wall Street money spigot began spewing again. Meanwhile, the American public was granted a fantastic opportunity to refinance mortgages and borrow against home equity at record low rates. Not surprisingly, American homeowners took this largesse in record numbers. And Fannie and Freddie, borrowing mainly from the money markets as we have discussed in previous letters, purchased a huge amount of these mortgages, distributing liquidity throughout the financial system. Fueled by the flood of liquidity, the stock market boomed, creating nearly $3 trillion of gains from October market lows. Consumers, flush with cash and huge capital gains, proceeded with a massive consumption binge resulting in overheated retail, computer, auto and home sales.

A seeming financial and economic miracle transpired, except for one critical hitch: An unprecedented mountain of new debt was created at rates that now look artificially low, leaving lenders increasingly underwater and financial markets generally under heightened systemic risk. We expect Wall Street, the holder of much of this new paper, to become increasingly nervous about it. Certainly, many firms are hoping desperately for a rescue in the way of decreasing interest rates. A return to lower yields would provide a bailout by allowing the profitable sale or securitization of large inventories of mortgages, home equity loans, and auto and credit card receivables. I also suspect the leveraged speculators have once again been caught highly exposed. Clearly, few in the speculating community expected rates to reverse and move sharply higher after the Fed's aggressive cuts. It is difficult not to presume unstable credit market conditions as we see a plethora of likely sellers of debt securities but few potential buyers.

INCREASING FINANCIAL STRAIN

We certainly view the significant and unrelenting decline in the government futures market as evidence of stress building in a highly leveraged and vulnerable financial system. And while credit spreads have not yet widened to the levels of last fall, they remain alarmingly wide. We are hearing more talk of a "two-tiered" debt market, a polite way of saying that many companies are losing access to new credit. This is particularly problematic for a corporate sector running huge and growing cash deficits. According to Merrill Lynch, cash shortfalls are forcing nonfinancial corporations to borrow an astonishing $400 billion a year. Moreover, Merrill Lynch states that the U.S. corporate sector has run negative cash flows now for the past seven quarters, the longest period ever. Their analysis puts the blame on collapsing prices and falling profits in a deflationary global environment and, of course, huge stock repurchases.

While we concur with the basic premise of Merrill Lynch's cogent analysis, there is much more to the story. A key unappreciated factor behind corporate America's growing cash flow deficit, and resulting huge borrowing requirements, is the Wall Street-inspired proliferation of businesses that require immense capital expenditures and still make no profits. Powered by the manic U.S. stock market and the credit bubble illusion of limitless capital this is a momentous boom running completely out of control in the so-called communications revolution. Simply staggering borrowings have and will continue to be required to fund the proliferation of telephony, Internet, wireless, satellite, cable and other telecommunications projects in development – the communications arms race. Unfortunately, it is difficult to know when, if ever, these heavy borrowers will generate positive cash flows. More likely, these huge debtors will instead generate big debt defaults.

So the makings of an onerous crisis are at hand: huge additional borrowing requirements by very poor credit risks and an acutely overleveraged financial system. Throw in a heavily indebted household sector with a negative savings rate and huge exposure to a stock market bubble and the vulnerability of the U.S. financial system and economy is manifest. This glaringly precarious situation could disintegrate quickly, particularly if

higher market rates incite another round of forced unwinding by the highly leveraged speculating community. It does not take much imagination to envisage another credit market dislocation with higher rates forcing levered players to liquidate their positions. This would likely dislocate the market sufficiently to cause the financing for many companies to be discontinued, particularly for the throng of high-risk creditors. Ironically, the technology and communications sectors, the heart and soul of today's manic stock market bubble, are acutely vulnerable to the developing liquidity and credit crunch.

BEAR MARKET RALLY DEFINITELY OVER FOR SMALL CAPS

Confirming the deterioration in the whole financial environment, small cap stocks are once again badly underperforming. The small cap Russell 2000 Index has declined 7% so far this year and remains 20% below its high of last April. Interestingly, the reversal in the Russell 2000 last spring proved an accurate auger of the financial storm that would hit the large caps just weeks later. The Russell 2000, being comprised of many marginal companies, is acutely vulnerable to any deterioration in the financial landscape, especially shifts in the availability of credit to more risky borrowers. Indeed, we see small caps as much the canaries in the mineshaft and today the canaries are gasping for breath. The S&P Small-Cap Index has a year-to-date decline of 10% and the S&P Midcap Index 9% decline. Utility stocks, which traditionally provide early warnings of imminent interest rate and stock market declines, have been under selling pressure, with the S&P Utilities Index posting a 7% decline.

And while the major stock market averages have thus far performed better than we would have expected considering faltering credit markets, there is mounting evidence of major deterioration below the market's surface. Certainly, the extraordinary narrowness of strength and erratic volatility are indicative of an imminent change in trend. Nowhere is this more visible than in NASDAQ. So far this year the top 20 NASDAQ stocks have gained 7.6% while the remaining 4,700 have declined 6%. But of late even the NASDAQ kingpins are faltering, witness the recent drubbing for Dell and Microsoft and the swift 10% decline for the NASDAQ 100 Index.

Actually, the bear market has returned for the majority of stocks. The cumulative daily NYSE and NASDAQ advance-decline line is faltering again, having already retraced about three-quarters of recent recoveries. And despite new records for the major market averages, the number of stocks reaching new highs are but a fraction of the numbers in previous years. In fact, new 52-week lows are currently running at three to four times new highs, certainly not indicative of a healthy marketplace. And in regard to volatility, the NASDAQ 100 Index now regularly swings in daily moves of between 3% and 5%. But wild volatility is not limited to NASDAQ. Over a three-week period in February, the Dow declined a tiny 19 points while the total of intraday hi-low price swings for the Dow was more than 1,900 points over 14 sessions—or 135 points a day. Market researcher James Stack stated that such intraday volatility has not been seen since 1929.

Richard McCabe, Chief Market Analyst at Merrill Lynch, made note of volatility and other technical factors in a recent analysis. As to recent erratic trading, he stated, "Such high volatility in a no net progress framework represents investor uncertainly and indecision, when emotionalism may overcome reason, and it is usually an indication that a trend reversal is in progress." Later he states, "All in all, the technical evidence appears to be continuing to increase that the market's October-January recovery trend is reversing and that the market is gradually moving into a new phase of decline. This downswing could eventually retrace a substantial part of, and possibly all, the averages' post-October recovery to provide a retest of the fall lows." With regard to bullish sentiment, he states, "Sentiment is just beginning to change from its recent exuberant bullishness, and there still appears to be too much complacency about downside risk. Further market weakness will likely be needed to correct this condition."

On a recent CNBC appearance, noted technical analyst Peter Eliades made several interesting comments

regarding sentiment. He stated that as far as professional investor's sentiment is concerned, *Investor's Intelligence* numbers now show that investment advisors have been more pervasively bullish than they have ever been in the history of the data. According to Eliades, as of this past week, "over 56% of investment advisors have been outright bullish for 12 consecutive weeks. That has never happened before in the history of the data going back to the early 1960s." Furthermore, Mr. Eliades' stated: "When the S&P 500 Index made new all-time highs in late January 1999, those highs were accompanied by the worst breadth figures since 1929." Moreover, 1998 was the 16th consecutive year in which the Dow did not trade below the prior year's low, with the prior record being eight years before the 1929 crash.

IDENTIFYING A BUBBLE

It is a historic fact that every major economic crisis since the invention and development of credit-creating banks in the early 18th century has originated in a financial crisis. Every financial crisis, in turn, has originated in prior credit and debt excesses. The key to understanding a bubble economy is understanding credit and debt. Preventing a crisis implies preventing the credit excesses that principally cause it. As explained in the last letter, the classical economists had, therefore, focused their attention on credit expansion as the one component in the system that creates additional purchasing power.

It is a historic fact that every major economic crisis since the invention and development of credit-creating banks in the early 18th century has originated in a financial crisis. Every financial crisis, in turn, has originated in prior credit and debt excesses.

What sank the east Asian economies? In hindsight, there is an inclination to blame the crisis on too much state interference, crony capitalism and a fragile, thinly capitalized banking system. But remember, even with these established fault lines these, countries enjoyed economic growth that was the envy of the rest of the world for decades. With generally moderate inflation rates, prudent fiscal policies and high private savings and investment ratios, they had become a model for many other countries. That this region might become embroiled in the worst financial crisis in the postwar period was never considered a realistic possibility.

Nevertheless, it took just a few years of stupendous financial excesses to inflict devastating economic and financial imbalances upon these economies. In the wake of suddenly weakening economic growth and ballooning trade deficits, their currencies and financial markets literally collapsed. What can cause such a dramatic structural break, moreover with such rapidity? What exactly went wrong?

In short, these countries experienced something new in recent years, more precisely, since 1995: They were drowned in floods of money and credit. The apparent primary cause was an unprecedented deluge of money from abroad seeking higher rates of return. With their high-yielding currencies and their image of economic miracles, these countries had become the favorite target for banks, investors and speculators in the industrial countries, where yields were plunging to unprecedented lows.

HOT MONEY ON THE RAMPAGE

Please note, we avoid speaking of international capital flows. Capital originates from savings, and financial markets are supposed to transmit savings from savers to borrowers. In fact, however, the plethora of money sloshing around world financial markets today bears no relation at all to available new savings. It comes overwhelmingly from an unfettered, highly- leveraged system for creating credit largely by way of carry trade.

This distinction between savings and leverage is far more than a question of semantics. It points to the most

important difference between capital flows in past and present. In the past, financial leverage used to play a minor role in the asset markets. The first major exception was the U.S. stock market boom of the 1920s with the heavy use of broker loans financing stock purchases on margin. In today's markets, heavy leverage—either through credit or through derivatives—is absolutely predominant, and nowhere more so than in the United States. Constraints that tend to limit credit and investment to current savings no longer exist.

Jointly, commercial banks and investment banks are creating money for financial speculation today virtually without limitation. Savings have become a drop in the ocean of financial leverage. When one single hedge fund is able to build positions of $200 billion on equity capital of $2-3 billion, it tells you that the world financial system is completely out of control. Nothing sounds more ridiculous than the Wall Street babble that liberalized and integrated global financial markets implement the most efficient allocation of capital resources to the benefit of world prosperity. It appears that today's policymakers, as well as leading bankers and economists, have to relearn the crucial difference between the essence of capital resources and leveraged hot money.

For somebody familiar with classical economics, it is conspicuously evident that the global and financial crisis which has ravaged the emerging countries had its decisive, primary cause in inordinate inflows of funds of three kinds: bank lending, hot short-term money and leveraged purchases of securities. Keen to prevent an appreciation of their currencies against the dollar through the ballooning money inflows, all central banks are engaged in massive dollar buying.

Foreign exchange reserves (overwhelmingly dollar reserves) of the emerging countries more than trebled in the 1990s. These reserves represented about half of the world's stock of reserve assets. About one half of total $1.1 trillion net inflows of funds to emerging markets during the 1990s ended up as central bank reserves which were recycled into U.S. Treasuries. This trend lasted until 1997.

THE ESSENCE OF A BUBBLE ECONOMY

While stabilizing the exchange rate, this dollar-pegging destabilized the banking systems of the emerging economies. Surging central bank reserves were matched by surging cash reserves (high-powered money) in the domestic banking systems. These cash reserves bear no interest, so the banks in the region embarked on a domestic lending boom, financing mostly excessive investment spending on real estate and industrialization.

Meanwhile, the resulting investment boom was preparing the conditions for its own undoing. Too many factories, warehouses, power stations, residential and office buildings started depressing the return on existing investments and dimming the profitability outlook of future investment projects. By 1997, more and more investors awakened to the fact that the countries in East Asia had grossly overinvested and would not be able to sustain the hefty returns of the previous few years. What finally pricked the bubbles in one country after another, were sharply lower exports, weakening economies and falling expectations. Hot money promptly took flight.

Credit excesses more or less dislocate the structures of demand and production and that is why they are a decisive, calamitous factor in the bubble economy precipitating the crisis. It would be comforting to think that some people in responsible positions of international finance would have warned of the strikingly visible excesses in domestic credit expansion and investment spending unfolding in these countries. Conspicuously, both aggregates had been growing grossly out of line with overall economic activity. Yet nobody took notice of these two spectacular imbalances. Policymakers, economists and markets have completely lost sight of the essentials of economic and financial equilibrium at the heart of classical economics.

The fact is that under American influence the conception of economic and financial equilibrium has narrowed to the focus on a single criterion: the inflation rate. A low or falling inflation rate is today widely seen

as the ultimate litmus test of economic balance and health. In the United States, the low inflation rates compel the Federal Reserve to monetary looseness, regardless of plain financial excesses and staggering economic imbalances. Even if the U.S. credit system and the trade deficit explodes, or the U.S. savings rate collapses, it counts for nothing when compared to the low inflation rate in warranting continuous monetary looseness, according to consensus economists.

THE CULPRITS IN ASIA

The International Monetary Fund has said the severity of the Asian crisis has been without precedent. In hindsight, this raises two sets of issues: first, the origin of the crisis and the outrageous failure of the international financial community to notice anything wrong before the crisis erupted, and second, appropriate measures to contain and to overcome the crisis.

One would think that the first issue would have provoked a spate of investigations. Is there anything more important for policymakers to do than to identify past policy mistakes in order to draw lessons for the future? Yet we note an ostentatious preference to evade this embarrassing question and to focus instead on of what should be done after the bubble has burst.

In a comprehensive report, the IMF declared that the international community, including itself, has a "far-reaching reassessment of the international architecture for crisis prevention and resolution" in the wake of the Asian crisis. Frankly speaking, I think the improvements the writers propose reveal a complete lack of understanding of the dynamics of asset bubbles, how they accrue and how they extend to bubble economies. Offering numerous words and data, the IMF simply misses this most important point. There is a clear aversion to discuss the bubble phenomenon.

Actually, it had been strikingly evident for some time that the Asian economies were exposed to tremendous credit excesses fueling spectacular investment booms in real estate and industrial infrastructure, just as earlier in the case of Japan. But in contrast to Japan, where both real estate and stock prices had skyrocketed, the Asian countries had the asset price inflation mainly in real estate. In general, stock prices remained subdued.

Major asset bubbles regularly burst with heavy damage to the economies concerned. What's more, the scale of this damage largely depends on the scale of the financial and economic maladjustments which have accumulated in the economy during the development of the bubble. That's why Austrian theory has always emphatically stressed that preventing credit excesses is the only way to prevent the later crisis, which, of course, requires the early recognition of such excesses.

What, exactly, were the culprits that sank the Asian economies? There were four of them: *first*, unusual monetary looseness in the industrial countries spurring unprecedented flows of hot money to the higher-yielding currencies of the emerging countries; *second*, the more or less strict pegging of these currencies to the lower-yielding dollar; *third*, widespread liberalization of capital flows; *fourth*, a domestic credit explosion feeding gross overbuilding and overinvestment in industrial plant. Some countries had investment ratios of well over 30%of GDP, more than twice their available savings.

Of these four culprits, as already explained, the first one was really the root cause of the whole Asian crisis. Just as clearly, these huge inflows of money were beyond the control of the recipient countries. Asia's specific policy mistakes were the maintenance of the dollar peg and liberalized capital accounts. Recycling a large part of the dollar inflows into U.S. Treasuries did not undo the increases in bank reserves associated with the initial dollar purchases. Losing control over bank reserves, the central banks implicitly lost control over domestic credit creation. That's how these strong-growth economies with excellent economic fundamentals were deformed into extremely unbalanced and vulnerable bubble economies within a few years.

NOW THE U.S. ECONOMY

These observations and considerations leave us a most important, final question. It concerns the complete failure of the international financial community to recognize the Asian bubble before it burst. Even though the link between the money inflows and domestic lending booms was manifest, American policymakers and the IMF persistently pressed these countries to maintain the two ill-fated measures which fostered these inflows—the dollar peg and the capital-account convertibility—with their stereotype, stupid arguments of efficient allocation of capital resources. They have yet to learn that financial leverage does not create capital.

It was a shocking failure by the international financial community to recognize the Asian bubble. We have just the same problem as regards the U.S. economy. In the last letter we stated: The main query for 1999 does not concern Europe, Japan, Asia or Latin America. It concerns the U.S. economy and the U.S. stock market. During the last three years, the U.S. economy has persistently surprised on the upside. But what was the overriding cause of this extraordinary economic strength? Is it the borrowed, fragile strength of a bubble economy? Or is it the thorough, durable strength of a "new paradigm" economy?

In the fourth quarter of last year, the U.S. economy has once again surpassed expectations. It was the fastest quarterly pace in 2 1/ 2 years and seemed to suggest still accelerating economic growth. I take these quarterly U.S. GDP numbers with a grain of salt until I see the details, however, because, owing to the annualization practice, they are prone to tremendous distortions when special factors come into play. Who really knows that the announced 6.1% growth rate for the fourth quarter reflects in actual fact a growth rate of 1.5% multiplied for annualization by four? Still fewer people are aware of the big distortions in this latest figure.

While U.S. economic growth in the fourth quarter was strong, it was nevertheless considerably exaggerated by the schematic annualization of a host of special factors, such as a surge in aircraft exports and, above all, the sharp production rebound from the depressed strike levels at General Motors. That was the biggest special factor in the quarter was, by far. According to a report in *Business Week*, GM alone added no less than 2.1 percentage points to the quarter's overall growth. That comes from annualization. The Commerce Dept. said that, excluding motor buying and small additions to inventories, real GDP would have grown 3.5%.

The GM strike distortion also affected equipment investment. On the surface, business outlays for machinery and high-tech gear jumped a stunning 21% in the fourth quarter, but that followed a 1% drop in the strike-affected third quarter. Lumping the two quarters together, equipment investment outlay rose at a 9.4% annual rate in the second half after 26.3% annualized growth in the first half. It seems companies are responding to the dramatic deterioration in their profits by paring their investment budgets.

But though economic growth in the fourth quarter was overstated, annual growth again outperformed predictions. Still, this cannot change our conviction that a Japanese-type financial and economic bubble has developed in the United States. U.S. economic growth and the stock price bubble are connected unlike any time since the Roaring 20s. The consumer-led momentum illustrates that link. Commenting on the Fed's easing last fall, Greenspan told Congress: "We were not trying to prop up equity prices." Yet that's just what the Fed did. After slowing a bit in the fall quarter, consumer spending skyrocketed in tune with the stock market back towards a 6% growth rate.

THE PRODUCTIVITY PARADOX

Wall Street is closing its eyes to the prodigious credit excesses and imbalances in the economy. Its bullish popular story for years now is that the U.S. economy is enjoying solidly-based long-term economic growth, accruing from capital efficiency, high productivity gains and, in particular, from the marvels of new technology. Ultimately, the bull story about the U.S. economy and the U.S. stock market boils down to the argument that U.S.

corporations make far greater and better use of the new technology than the rest of the world, granting them therefore superior productivity gains and profit growth which have justified the fabulous run up of the stock market.

Let's examine and compare the evidence for the two opposite views about the U.S. economy. What exactly is the evidence of the fabled new paradigm economy, and what is the evidence of a bubble economy? As to the first, the trouble is that its protagonists don't bother about statistical proof. Strong economic growth, the past surge in profit margins, falling inflation rates and the explosive gains in stock prices are all seen as part of the pattern that many believe simply could not have happened were it not for the newfound miracles of America's productivity renaissance.

In particular, the bulls have seized on the fact that productivity has lately climbed at an annual rate of nearly 2%, almost double the rate the economy has grown since the early 1970s. Still, annual productivity growth over the whole expansion any period, since 1992, has been no more than the long-term average of 1%. Even 2% would be nothing to write home about, since it is the European long-term average.

On a closer look, the U.S. productivity gains of late have an obvious reason, although few people are aware of it. Over the last three years, real GDP growth has been given a supercharged boost by a structural change in the output and demand pattern. Explosive growth of the computer industry and the dizzying fall in the prices for computer equipment have accounted for up to a third of the growth in real GDP since 1995, while the sector accounts only for 2% of total employment. Essentially, this implies fabulous productivity gains in this sector which more than explains the recorded improvement in aggregate productivity.

Is this the long awaited payback from the technology binge? Definitely not. The statistics make it abundantly clear that the higher productivity gains, as recorded in the last years, have occurred in the narrow high-tech sector, where they result from soaring high-tech *output*, and not from high-tech *use* in the broad economy. In other words, the higher recent productivity gains largely reflect the sky-rocketing increase in the computer industry where capacity is soaring at a 35% annual rate. In the large rest of the economy, capacity has been growing at an anemic pace of 2.5%.

This is America's great productivity paradox and a difference of absolutely crucial importance. Essentially, it's the use of computers that makes economic sense of their production, not vice versa. Corporate America is spending in excess of $220 billion on IT hardware, and probably three to four times that amount on supporting software. Yet the benefits of this widely proclaimed capital spending boom in information technology remain elusive, as growth in the white-collar services sector remains labor-intensive as ever. Observing these facts, we wonder whether Corporate America is not heavily overinvesting into information and underinvesting into production. If so, it is a grossly unbalanced investment structure which has its nemesis in the huge trade gap.

PROFIT TROUBLE

Many bulls like to interpret the explosion in stock prices over recent years as indirect confirmation of unmeasured efficiency gains of Corporate America, boosting profit margins. The first thing to say to this perception is that since early 1995 stock prices, as measured by the S&P 500, have jumped 185%, or 46% per annum, against an overall increase in profits after tax of just 36%, or 9% per annum. So stock prices have increased five times as fast as profits and market valuations have skyrocketed to levels never seen before.

True, corporate profits had between 1991 and 1995 scored an unusually rapid increase. But that was due to several one-off factors, of which sharply falling interest rate costs were the most important. Adjusting for these factors, and measuring profits before interest, taxes and depreciation, the profit performance over the whole cycle has been rather below average. Since the third quarter of 1995, the profit trend is down. Given the acceleration in economic growth, this downtrend appears rather ominous.

Productivity and profits are key variables in determining long-term economic growth. If the new paradigm story had any substance, it would have to show in these two aggregates in the first place. But since their measured performance fails to show any extraordinary improvement, Wall Street's new era apostles simply dispute the validity of the unfavorable statistics.

The statistical evidence points manifestly to unprecedented borrowing binges of corporations and consumers as the chief propellant of the buoyancy both of the U.S. economy and its financial markets.

What, then, explains the U.S. economy's growth and exceptional performance over the last few years? In short, it is the very same force that has fueled Japan's bubble economy in the late 1980s and the east Asia's bubble economies in the last 1990s: *prodigal credit and debt. Asset bubbles and resulting bubble economies always have one and the same root cause: credit growth vastly in excess of economic activity, as measured by the growth in nominal gross national product.* Implicitly, such a credit expansion is partly utilized for leveraged purchases of assets, tangible or financial, boosting their prices out of relation to the movements of the general price level. Just consider that in 1998 mergers and acquisitions in the United States amounted to about $1,300 billion, more than double the amount in the year before.

DEBT EXPLOSION

What, then, has been driving the U.S. economy? Technology? Forget it.

The outstanding feature of the U.S. economy in the last few years has been a virtual debt explosion, and debt is incurred in order to spend it. While the government sector went into surplus, consumers and businesses embarked on an unprecedented borrowing binge. Last year, their combined debt growth exceeded $1 trillion, after $745 billion in 1997, $580 billion in 1995, $557 billion in 1996, and $416 billion in 1994. On top of this, the financial sector borrowed another $1 trillion.

Such a glut of credit out of all proportion to GDP growth is the very cause and hallmark of an asset price bubble. Ironically, it is a standard bullish argument that the market is liquidity-driven, referring to the fact the money supply has been growing faster than GDP. Nobody, though, cares to reflect upon the crucial question of the source behind this excess liquidity. Given the savings collapse, this liquidity is essentially coming from excessive credit and debt creation. Moreover, few seem to realize that "liquidity-driven" and "technology-driven" are incompatible explanations for growth. In sync, they don't make sense. It is either one or the other.

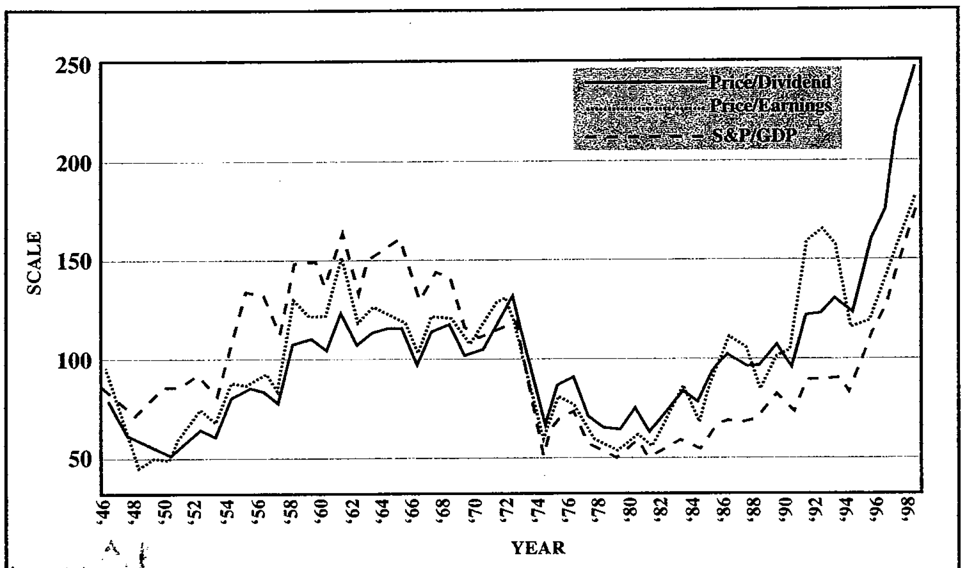
The statistical evidence points manifestly to unprecedented borrowing binges of corporations and consumers as the chief propellant of the buoyancy both of the U.S. economy and its financial markets. Making this statement, our focus is on credit and debt aggregates because they capture a far broader financial spectrum than the money supply. First, all money today is credit money in the sense that it is created through credit expansion; second, money creation reflects only that part of credit creation which takes place through bank lending; third, money is actively used, not only by depositors, but also by borrowers; fourth, credit statistics give valuable insights into the usage of credit; fifth, credit growth implies corresponding debt growth.

As already mentioned, U.S. businesses and consumers jointly borrowed more than $1 trillion last year. This debt growth was associated with an increase in broad money (M3) by only $637 billion. The difference between the two numbers is certainly relevant. But which of the two is more informative about what's going on in the economy? No doubt, it is credit. Borrowed money tends to be spent. To the extent that it is spent on goods and services, it creates income.

We have come to the worst imbalance in the U.S. economy. It concerns the consumer and lies in the devastating impact of the stock price bubble on the personal savings rate. Huge wealth effects from soaring stock prices and heavy use of credit gave a colossal boost to consumer spending. As a result, consumers accounted last year for a disproportionate share of GDP growth of 85%, compared to 67 % normally. GDP growth has become unusually skewed toward consumption and this extremely unbalanced pattern may even worsen in 1999, since exports, capital spending and housing are likely to provide less support to growth this year than they did last year.

By no means has the household sector been alone in spending vastly beyond its means. The same has been done by the corporate sector. During the 12 months ending September 1998, corporations added $359.3 billion to their outstanding debt, up 72%from the preceding 12 months. Of this amount no less than $158 billion was used for net stock repurchases. Remarkably, this happened in the face of record-high stock valuations, falling profits and stagnant internal funds, implying that the stock buy-backs were completely debt-financed. The net result was a soaring corporate "financing gap" (as the corporate deficit is termed in the Fed's quarterly flow of funds accounts). The outcome of both sectors heavy spending beyond their revenue has been the highest ever financial deficit in terms of GDP. Is this a bubble, or not? Yes. What's more, it's a particularly extreme case.

The final question is always what kind of impact an asset price bubble will have on the economy.



Altogether, the statistical evidence of a badly unbalanced bubble economy in the United States is overwhelming. Ludicrously, though, the bullish Wall Street consensus turns every proven economic principal on its head by declaring the very symptoms of a bubble economy as evidence of a miraculous economic revival. We have come across quite a few articles in first-class papers, in which the authors contend that *the low savings rate in these times is a sign of economic health.* Since foreigners are ready lenders and capital gains are so easy—both incorrectly taken as signs of health—why worry about domestic savings. The associated, unsustainable gross imbalances inflicted on the economy are simply not understood.

We consider it most important to verify beyond any doubt whether or not America has a bubble economy with entrenched major economic and financial imbalances because a bubble inherently predisposes the afflicted economy to a painful bust. Once a big credit and asset bubble bursts, the inevitable result is deflation and prolonged recession. America's credit excesses have been much too profligate to end with a soft landing.

The consensus is now looking for further strong growth in the short term and a moderate slowdown later. But as we have already explained, the fourth-quarter GDP growth data were heavily distorted to the upside. In the absence of the special factors, the growth rate would have been somewhere between 3-4%. To slow economic growth to 2%, it would take only a modest slowdown from exports, capital spending and

consumption. The stock market, by the way, doesn't need a crash to depress the economy. If the market merely stabilizes, it deprives numerous consumers of new capital gains.

OUTLOOK:

On the surface, the U.S. economy seems to be bursting with underlying strength, but that is false. What we see, in reality, is buoyancy that comes from excessive and unsustainable borrowing binges, both from consumers and businesses. It is a bubble economy, pure and simple.

The crucial distinguishing feature of a bubble economy is credit and debt growth substantially in excess of GDP growth. U.S. credit and broad money growth are comparable to Japan in its bubble days during the late 1980s.

The growing perception that the Euroland economy is weakening while the U.S. economy is strengthening has led to a softening of the euro. But that trend will dramatically reverse, once evidence of a U.S. slowdown appears. The borrowing and spending excesses now leave the U.S. economy vulnerable to a sharp slowdown.

Present worries about the growth of the U.S. economy have been painful to holders of long-term bonds, and have caused pronounced spikes in bond yields. This will ultimately pave the way for a sustained decline in yields.

In order to have a sustained rise in interest rates in the United States, it would need a synchronized world economy recovery. Instead, we see a synchronized global downturn, as the sharply slowing U.S, economy will join the enfeebled rest of the world.

The rise in U.S. equity prices since last October has been impressive, as measured by the major stock indexes. However, a look below the surface reveals a picture of overwhelming bearishness. Less and less stocks have been advancing and more and more stocks declining. Liquidity is vanishing.

The situation in Japan remains dismal. Every major indicator is still declining, including industrial production, exports, investment and consumer spending, and profits. Credit is contracting. It is an open question, whether the government's efforts, at best, offer a cushion to the economy, or could actually be counterproductive.

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